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Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-1201

MOBIL OIL CORPORATION
Appellant,

v.

COMMISSIONER OF TAXES OF VERMONT,
Appellee.

On Appeal from the Supreme Court of Vermont

BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS AMICUS CURIAE IN SUPPORT OF APPELLANT

COMMITTEE ON STATE
TAXATION FOR THE
COUNCIL OF STATE
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INDEX

Page

INTRODUCTORY STATEMENT 1

INTEREST OF AMICUS CURIAE 2

QUESTIONS PRESENTED BY APPELLANT 2

ARGUMENT 3

A. The Tax On Appellant's Dividends Violates The Due Process Clause, Because There is no Connection Between Its Business, Property, or Operations in Vermont and the Dividends Taxed 3

B. The Inclusion in Part or in Whole of Dividends From Domestic and Foreign Subsidiaries in the Apportionable Base of the Tax Subjects the Corporation to a Risk of Multiple Taxation Prohibited by the Commerce Clause. 13

C. The Taxation of the Foreign Source Dividends on an Apportioned Basis is Invalid on the Grounds that it Frustrates Federal Policy in Regulating Foreign Commerce. 18

CONCLUSION 27

APPENDIX A 1A

Discrimination In Selectively Paralleling The Internal Revenue Code.

TABLE OF AUTHORITIES

CASES: Page

Chestnut Securities Company v. *Oklahoma Tax Commission*, 125 F. 2d 571 (10th Cir. 1942) *cert. denied*, 316 U.S. 668 (1942) 12

Complete Auto Transit, Inc. v. *Brady*, 430 U.S. 274 (1977) 3, 6, 13

Connecticut General Life Insurance Co. v. *Johnson*, 303 U.S. 77 (1938) 9

Curry v. *McCanless*, 307 U.S. 357 (1939) 12

Evco, d.b.a. *Instructional Designs* v. *Jones*, 409 U.S. 91 (1972) 17

First Bank Stock Corporation v. *Minnesota*, 301 U.S. 234 (1937) 12

Freeman v. *Hewit*, 329 U.S. 249 (1946) 3

Frick v. *Pennsylvania*, 268 U.S. 473 (1925) 9

General Motors Corp. v. *Washington*, 377 U.S. 436 (1964) 17

Hans Rees' Sons, Inc. v. *North Carolina*, 283 U.S. 123 (1931) 9

Japan Line, Ltd. v. *County of Los Angeles*, 47 U.S.L.W. 4477 (1979) ..... *passim*

Michelin Tire Corporation v. *Wages*, 423 U.S. 276 (1976) 13

Miller Bros. Co. v. *Maryland*, 347 U.S. 340 (1954) 4

Moorman Manufacturing Company v. *Bair*, 437 U.S. 267 (1978) ..... *passim*

Norton Co. v. *Department of Revenue*, 340 U.S. 534 (1951) 6

St. Louis Cotton Compress Co. v. *State of Arkansas*, 260 U.S. 346 (1922) 10, 23

State Board of Insurance v. *Todd Shipyards Corp.*, 370 U.S. 451 (1962) 10, 23

Underwood Typerwriter Co. v. *Chamberlain*, 254 U.S. 113 (1920) 9

Virginia Electric & Power Co. v. *Currie*, 254 N.C. 17, 118 S.E. 2d 155 (1961) 14

Washington Revenue Department v. *Association of Washington Stevedoring Companies*, 435 U.S. 734 (1978) 16

Wheeling Steel Corporation v. *Fox*, 298 U.S. 193 (1936) 12

Wisconsin v. *J.C. Penney Co.*, 311 U.S. 435 (1940) 3

STATUTES:

Internal Revenue Code

§243 14

§§243-247 ..... 11, 25

§§901-902 11

22 U.S.C. §2351 18

50 U.S.C. App. §2402 20

CONSTITUTION:

Commerce Clause, United States Constitution Article I, Sec. 8, cl. 3 ..... *passim*

Due Process Clause, United States Constitution, Amendment XIV ..... *passim*

OTHER AUTHORITIES:

The Bureau of National Affairs, Inc., "Daily Tax Reports" No. 110 (June 6, 1979) at J10 22

National Foreign Trade Council, Inc., "The Case for 'Deferral'" (August, 1978) 15

Hearings, Subcommittee on State Taxation of Interstate Commerce of the Senate Committee on Finance, 93rd Cong. 1st Sess., p. 274 (1973) 16

Hearings, Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, 89th Cong. 2d Sess. Vol. 2, p. 1793 (1966) 16

Peters, "The Distinction Between Business Income and Nonbusiness Income," 1973 So. Calif. Tax Inst., pp. 266-7 15

Treasury Model Income Tax Treaty of May 17, 1977, Article 23 23

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BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS AMICUS CURIAE IN SUPPORT OF APPELLANT

I. INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation of the Council of State Chambers of Commerce as *amicus curiae* in support of the Appellant in the above-captioned case. The consent of the Attorney for the Appellant and the Attorney for Appellee has been obtained. The letters of consent have been filed with the Clerk of this Court.

II. INTEREST OF AMICUS CURIAE

The motion of the Committee on State Taxation of the Council of State Chambers of Commerce (COST) for leave to file a brief as *Amicus Curiae* in support of Appellant's Jurisdictional Statement was granted by this Court on May 14, 1979. The motion which was granted and the brief as filed sets forth the interest of COST as *Amicus Curiae* and background of the problems involving state taxation of dividend.

III. QUESTIONS PRESENTED BY APPELLANT

Where a State imposes an income tax on a corporation that is engaged in foreign commerce and the corporation is neither organized under the laws of the taxing State nor maintains any commercial domicile in that State, and the apportionable base of the income tax includes dividends received by the corporation from foreign subsidiaries and domestic and foreign non-subsidiaries conducting all their business in foreign countries:

(1) Does the tax violate the Due Process Clause of the Fourteenth Amendment where the only connection between the corporation and the taxing State is the sale of products in that State?

(2) Does the inclusion of the foreign source dividends in the apportionable base of the tax subject the corporation to a risk of multiple taxation prohibited by the Commerce Clause?

(3) Is the taxation of the foreign source dividends on an apportioned basis invalid on the ground that it violates the Commerce Clause, frustrating Federal policy in regulating foreign commerce?

IV. ARGUMENT

A. The Tax On Appellant's Dividends Violates The Due Process Clause, Because There Is No Connection Between Its Business, Property, Or Operations In Vermont And The Dividends Taxed.

The Court in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 280-281 (1977), embraced the view expressed by Justice Rutledge in *Freeman* v. *Hewit*, 329 U.S. 249 (1946), that "... a state tax is unconstitutional only if the activity lacks the necessary connection with the taxing state to give "jurisdiction to tax,' ... or if the tax discriminates against interstate commerce, or if the activity is subject to multiple taxation", and voiced its approval of a practical analysis that would sustain a State tax on interstate commerce if it "... is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Id.*, at 279.

The line of decisions which articulate the analysis currently accepted by this Court has its origin in *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435 (1940). Therein, the Court expressed the conceptual underpinnings of its present day practical approach to constitutionality in the following words:

> For constitutional purposes the decisive issue turns on the operating incidence of a challenged tax. A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has

> afforded, to benefits which it has conferred by the fact of being an orderly, civilized society.
>
> . . . That test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return. (p. 444)

The most recent application of this analysis to a State tax imposed on income from operations in interstate commerce is found in *Moorman Manufacturing Company* v. *Bair*, 437 U.S. 267 (1978). Therein it is stated that the Due Process Clause places two restrictions on the power of the States to tax income: first, there must be some definite link between the income-generating activities and the taxing State; and second, the income sought to be taxed must be reasonably related to the activities in the State.

While both of these restrictions protect against the extraterritorial extension of a State's taxing power they are not synonymous. The first requirement necessitates a showing that the person charged with the tax conducted activities in the State which gave rise, wholly or in part, to the income to which the tax applied. This restriction runs to the jurisdiction of the State over the subject; *i.e.*, income taxed, rather than over the person liable therefor. *Miller Bros. Co.* v. *Maryland*, 347 U.S. 340 (1954). The decisions of this Court have consistently established that Due Process requires an initial showing that some part of the activities giving rise to the specific income being taxed occurred in the taxing State.

In the case before this Court, Vermont is seeking to tax the dividend income derived by Mobil from the ownership and management of capital stocks of a large number of domestic and foreign corporations (J.S., p.5).[1] Thus, the initial test imposed by the Due Process Clause requires that Vermont show that Mobil's instate activities included some exercise of its ownership or management over its stock holdings. The facts in the instant case not only fail to establish the existence of this condition but, indeed, show the converse. Mobil exercised ownership, control and management over its stock holdings in the State of New York, not Vermont. (*IBID.*) The immediate event which gave rise to the dividend income; *i.e.*, the receipt of the dividends, occurred in New York, not Vermont. (*IBID.*) Mobil's activities in Vermont were directed solely toward the realization of income from the wholesale and retail marketing of petroleum and related products. (J.S., p.4) It had no oil or gas production or refinery facilities in Vermont. (J.S., p.5) Further, the stipulated facts fail to show any connection between the operating income derived from the limited Vermont activities and the dividend income realized by Mobil from its New York stock management activities. In addition, the payor corporations conducted no business, maintained no offices, had no employees, owned or leased no property, and derived no income from sources within the State of Vermont having derived all, or all but an insignificant portion, of their income from sources outside the United States. (*IBID.*)

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[1] The term "domestic" corporation refers to a corporation organized under the laws of one of the States, and "foreign" corporation to a corporation organized under the laws of a foreign country.

To hold that the vital link between Mobil's activities in Vermont and the dividend income realized by Mobil in New York can be presumed from the fact that Mobil engaged in the marketing and distribution of products in Vermont would constitute a marked departure from past decisions of this Court. *Norton Co.* v. *Department of Revenue*, 340 U.S. 534 (1951). The sole issue here is the power of Vermont to tax the dividend income of a corporation neither organized under the laws of Vermont nor maintaining any commercial domicile in that State. This issue merely requires an examination of the dividend process for its resolution. In the present case, dividends flow, in part, in foreign commerce—from the domicile of the foreign payors to appellants' commercial domicile in New York, and, in part, in interstate commerce—from the domicile of the domestic payors to Mobil's domicile in New York. In neither case is there any contact with the State of Vermont. COST respectfully submits that Vermont's efforts to tax such dividend income do not meet the test, under either the Due Process Clause of the 14th Amendment or the Commerce Clause of the Constitution, which this Court has reaffirmed for a permissable State tax burden on either interstate or foreign commerce. *Complete Auto Transit Inc. v. Brady, supra; Moorman Mfg. Co. v. Bair, supra; Japan Lines, Ltd. v. County of Los Angeles*, 47 U.S. L.W. 4477 (1979). Under these decisions, there clearly is an impermissible overreaching of jurisdictional boundaries and burden placed on commerce by Vermont for there is neither a Vermont nexus over the dividend income nor does Vermont give anything with respect to the dividend income in question for which it can ask return—it has afforded no protection, conferred no benefits nor granted any opportunities

with respect to the realization, payment or receipt of the dividends.

The second Due Process restriction on a State's power to tax income; *i.e.*, the requirement that there be a reasonable relationship between the income sought to be taxed and the taxpayer's activities in the taxing State, does not arise until the first requirement, the jurisdictional link, has been found to exist. Since there is no jurisdictional link between Mobil's dividend income and the State of Vermont, the decisions of this Court relative to the limitations on State action generated by the second Due Process restriction are not applicable. This second restriction addresses what is essentially a measurement problem. When there is a jurisdictional link with the specific income which a State seeks to tax and that link is not exclusive, Due Process requires that the quantum of the income taxed bear some rational relationship to the activities which provide the jurisdictional link; otherwise, the exercise of taxing authority by one State could interfere with a like right of sister States. When several States have a link to the same income; *e.g.*, income from interrelated operations conducted in more than one State, the Due Process Clause requires at least the use of rough measuring devices to reconcile the valid jurisdictional claims of each State. However, when, as in the instant case, there is no activity linking Mobil's Vermont operations with Mobil's dividend income, measurement is not an issue. It takes nothing to measure nothing.

The State of Vermont places much reliance on this Court's recent decision in *Moorman Manufacturing Company* v. *Bair, supra.* (J.S.App. C, pp. 24a, 26a, 29a) This dependence is misplaced. Unlike the instant

case, Iowa's jurisdiction to tax the particular income considered had been conceced in *Moorman*. The net income Iowa sought to measure and tax was operating income, resulting from selling and warehousing carried on in the State, and determined by netting expenses against receipts from the sale of goods occurring in a specified period during which Moorman conducted its intrastate and interstate business. Since the earning of such net income is not a *discrete taxable event*, and since Moorman's accounting records did not show the net income specifically derived from its activities in Iowa, the State was unable to ascertain the exact source of income. The State, therefore, relied on an apportionment formula to approximate the net income attributable to Moorman's activities in Iowa. In *Moorman*, Iowa did not include the taxpayeres dividend income in the apportionable income base (437 U.S. at 260). The only controversy in *Moorman*, then, was whether the formula produced a sufficient approximation of the net income earned in Iowa to be legally acceptable.

In the present case, unlike *Moorman*, the extraterritorial taxation which occurs is *not* caused by formulary imprecision, but rather by lack of jurisdiction over Mobil's holding of stock on which the dividends were paid, over its receipt of dividends, and over its management and control of investments—incurable defects no matter what the formula.

Vermont's assertion of a right to tax unrelated dividend income is particularly pernicious since, if it is granted, Vermont would be permitted to tax the dividend income without recognizing either the New York activity of Mobil or the payor activity in other States and nations in its apportionment formula. To

confirm Vermont's taxation of Mobil's dividend income would: (i) grant similar authority to every State in which Mobil conducts like activities; (ii) allow all States to determine the portion of such dividend income subject to taxation without regard to the competing claims of other States; and (iii) insofar as dividend income is concerned, abandon the long-standing Constitutional doctrine that a State cannot tax income which is "in no just sense attributable to transactions within its jurisdiction". *Hans Rees', Inc.* v. *North Carolina*, 283 U.S. 123, 134 (1931). See *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920). Dividends would become a particularly unattractive form of income, because of their unique vulnerability to taxation everywhere without regard to either of the established Due Process tests. This result is not required since the amount of the income which Vermont seeks to tax is fixed at the moment of the discrete taxable event (*i.e.*, the receipt of the dividend)—an event which in this case took place in New York, not Vermont.

This court has seen through state tax policies such as that proposed by Vermont in this case and has stricken them down, as in *Frick* v. *Pennsylvania*, 268 U.S. 473, 489 (1925):

> While a state may shape its tax laws as to reach every object which is under its jurisdiction, it cannot give them extraterritorial operation.

See also *Connecticut General Life Insurance Co.* v. *Johnson*, 303 U.S. 77 (1938).

These cases clearly indicate that such an imprecise apportionment formula as approved in *Moorman* can measure an existing link or relationship required by

the Due Process Clause; however, the application of such formulas does not create the definite link which must be found to exist before apportionment may be applied. The means cannot be the sole justification for their implementation. The Due Process Clause requires more than jurisdiction over the person (*i.e.*, individual or corporation) required to pay the tax; it also requires nexus between the income which is the subject of the tax and the activities or property in the taxing State.

St. Louis Cotton Compress Company v. *State of Arkansas*, 260 U.S. 346 (1922), and *State Board of Insurance* v. *Todd Shipyards Corporation*, 370 U.S. 451 (1962), establish that the jurisdiction of a State over activities that transpire within its borders *ends* with that border and cannot be used in such a way as to modify legitimate activities that occur outside its boundaries. In those cases, this Court examined Arkansas and Texas laws designed to create tax advantage for those insuring instate property with insurers licensed in the State. This the Court would not allow, concluding in *Cotton Compress* at 349:

> It is true that the state may regulate the activities of nondomiciliary corporations operating within the state but it cannot regulate or interfere with what they do outside.

If Due Process considerations preclude the States of Texas and Arkansas from framing their tax laws to discourage use of insurers not licensed in those respective States, how can the same Clause permit Vermont to levy an income tax whose effect is to discourage investment in foreign as opposed to domestic corporations by imposing a tax on an apportionable, taxable income, base which in general included 100%

of the dividends received from foreign corporations while allowing the dividends received deduction, in determining such base, for dividends from qualified domestic corporations?[2]

Over the nearly 111 years since the adoption of the Fourteenth Amendment to the Constitution, the decisions of this Court relative to the scope of the Due Process Clause have fostered the belief of persons and States that dividend income is subject to taxation outside the State in which the recipient has a legal or commercial domicile only if the owner of the dividends chooses to hold and manage such property in another State. Consistent with this position on the law, seven states now provide for the taxation of all dividend income received by corporations domiciled therein (J.S.App.F, p.39a). If this Court should now see fit to change this position by holding that Vermont can subject part of Mobil's dividends to taxation, the Court will be faced with the necessity of adjudicating the conflicting claims of these seven States and States which seek to follow the path of Vermont (*IBID*) or, in the alternative, create a new significant impediment to the formation of sorely needed investment capital by imposing thereon compounding State tax burdens. Such a policy would discourage new U.S.

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[2] Vermont law selectively parallels provisions of the U.S. Internal Revenue Code; *i.e.*, allows dividends received deduction (I.R.C. §§243-247), includes foreign source dividends in gross income (I.R.C. §61) and ignores the foreign tax credit concept (I.R.C. §§901-904). (J.S. p.5 footnote4) This policy clearly works a discrimination against foreign as opposed to domestic dividends which is inconsistent with the proper exercise of State jurisdiction and would, in addition, appear to work a discrimination under the Equal Protection Clause of the U.S. Constitution. For further amplification of this discriminatory effect refer to argument C. herein and see Appendix A.

investment in equity capital, deprive this nation of the fruits of capital formation, erode private employment opportunities and leave U.S. citizens alone among modern industrial nations in their inability to make full use of the corporate form for the organization of national and international businesses. Matched against these consequences, the claim of Vermont to tax dividend income which admittedly accrued from activities outside its boudaries represents the elevation of a State's parochial desire for revenue (J.S.App.C, p.28a) above a paramount concern of our Federal Union.

The jurisdictional right to levy taxes on dividends should be restricted to the State of commercial domicile, under the Constitutional doctrine—which remains applicable to intangibles—that movables follow the person. Dividends are "localized at the owner's domicile for purposes of taxation" if they do not have a "business situs" in another State. *Wheeling Steel Corporation* v. *Fox*, 298 U.S. 193 (1936); *First Bank Stock Corporation* v. *Minnesota*, 301 U.S. 234 (1937); *Curry* v. *McCanless*, 307 U.S. 357 (1939); *Chestnut Securities Company* v. *Oklahoma Tax Commission*, 125 F.2d 571 (10th Cir. 1942) *cert. denied*, 316 U.S. 668 (1942).

B. The Inclusion In Part Or In Whole Of Dividends[3] From Domestic And Foreign Subsidiaries In The Apportionable Base Of The Tax Subjects The Corporation To A Risk Of Multiple Taxation Prohibited By The Commerce Clause.

For state taxes on foreign commerce, the Court in *Japan Line, Ltd.* v. *County of Los Angeles*, 47 U.S.L.W. 4477 (1979), mandated two further tests to those set forth in *Complete Auto Transit, supra:* first, whether the tax, notwithstanding apportionment, poses a substantial risk of multiple taxation; and second, whether the tax prevents the Federal Government from (quoting *Michelin Tire Corporation* v. *Wages*, 423 U.S. 276, 285) "speaking with one voice when regulating commercial relations with foreign governments." In *Japan Line*, this Court struck down a property tax applied to cargo containers, owned by a Japanese firm and used in foreign commerce, which were temporarily present in California. Although *Japan Line* involved property taxes, there is nothing unique to taxes on tangible property that would limit the controlling principles of the case to such a narrow target. They should be held equally applicable here.

Whether or not the Vermont tax satisfied the Commerce Clause tests fixed by *Complete Auto Transit*,—the fairness of an apportionment scheme that principally consists of factors totally unrelated to the dividend income being taxed is, at best, questionable,

[3] More than 99% of the dividends at issue were received by Mobil from domestic and foreign corporations deriving all, or all but an insignificant portion, of their incomes from sources outside of the United States.

Virginia Electric & Power Co. v. *Currie,* 254 N.C. 17, 118 S.E.2d 155 (1961)—it clearly offends the additional tests related to multiple taxation and impairment of Federal sovereignty set forth in *Japan Line.*

The Vermont tax creates more than a risk of compound taxation of dividends paid out of incomes from sources outside of the United States; rather, it compounds taxation in fact. The operating income of foreign and domestic corporations derived in foreign countries is first subject to the taxes of the host foreign countries, thus reducing the amount available to be paid out as dividends. The dividends declared by the foreign corporations and the foreign source earnings of domestic corporations are also subjected to, or are susceptible to, a tax by the host foreign countries when paid to Mobil or the domestic corporations in which Mobil has stock holdings, respectively. Both of these taxes are entirely outside U.S. control. The dividends received directly by Mobil from foreign corporations and the foreign source earnings of domestic corporations in which Mobil holds stock may be further depleted by Federal income taxes when the cumulative effective foreign income tax rate is less than the U.S. tax rate. (With respect to dividends Mobil receives from domestic corporations operating outside the U.S., multiple corporate taxation is avoided in part, at the Federal level, by operation of L.R.C. §243 which permits Mobil to exclude 85% of such dividends.) This is a legitimate exercise of U.S. national policy adopted by Congress against the background of clear knowledge of the taxing authority exercised by foreign countries.[4] If this court approves the Vermont tax, the dividends received by Mobil from foreign source earnings will be subjected to still another wave of State taxation.

[4] "Since 1913, when the U.S. income tax was established, a corporation and its shareholders have been taxed separately. The corporation is taxed on its earnings and the shareholder is taxed when and if the corporation pays a dividend. The same principle applies when the corporation is organized under the laws of a foreign country or parent, or controlling shareholder is a U.S. company. The income of the foreign subsidiary is not taxable to the parent corporation unless and until the subsidiary pays a dividend to the parent. The principle, whereby earnings of overseas subsidiaries are not taxed until remitted to the U.S. parent, is popularly but incorrectly referred to as 'deferral,' whereas in fact, there can be no 'deferral' because under U.S. tax law a taxpayer is not taxed on income until it is received. The main exception in the U.S. tax law to this general rule is in Subpart F of the Internal Revenue Code, pursuant to which U.S. shareholders are taxed currently on the income of a controlled foreign corporation when the nature of the corporation and its sources of passive income indicate that tax avoidance was sought.

The U.S. system for taxing U.S. parents of foreign subsidiaries conforms to the internationally accepted system of taxing income derived from foreign trade and investment. This system recognizes that the primary right to tax income earned abroad rests with the host country. Some industrialized countries do not tax foreign source income at all. Others, including the United States, tax income of foreign subsidiaries only when remitted to the parent, and double taxation of foreign-source income is avoided by means of the allowance of the foreign tax credit.

The present system of taxing U.S. parent companies on the earnings of foreign subsidiaries serves to achieve the national objectives of restoring a more favorable balance of trade, stimulating growth in domestic employment and increasing the competitive position of foreign operating entities in marketing U.S. products and services overseas." National Foreign Trade Council, Inc., "The Case for "Deferral' ", pp. 12-13, (August, 1978).

[5] Peters, "The Distinction Between Income and Nonbusiness Income," 1973 So. Calif. Tax Inst., pp.266-267.

the leave of this Court, all States in which the corporate recipient of the dividends does business will have the right collectively to tax the entire dividends received from foreign sources, a right already exercised by the foreign countries in which the dividends were earned and by the U.S. Federal government. The compounding of tax burdens which would be permitted would exist despite any action by Congress or this Court to rationalize conflicting State claims through the adoption of uniform allocation and apportionment criteria.[6] This Court explained in *Japan Line* at 4480-4481:

> In order to prevent multiple taxation of interstate commerce, this court has required that taxes be apportioned among taxing jurisdictions, so that no instrumentality of commerce is subjected to more than one tax on its full-value. The corollary of the apportionment principle, of course, is that no jurisdiction may tax the instrumentality in full. . . . Yet neither this court nor this nation can insure full apportionment when one of the taxing entities is a foreign sovereign. . . . Hence, whereas the fact of apportionment in interstate commerce means that "multiple burdens logically cannot occur," *Washington Revenue Department* v. *Association of Washington Stevedoring Co.*, 435 U.S. 734, 746-747, the same conclusion as to foreign commerce, logically cannot be drawn.

[6] "If taxation of dividend income received by one corporation from another is not of itself an impediment to interstate commerce, it is difficult to understand upon what basis of national interest a state in which a corporate taxpayer maintains its commercial domicile may be forbidden to tax all of the dividend income received by that corporation." Hearings Before the Subcommittee on State Taxation of Interstate Commerce of the Senate Committee on Finance, 93d Cong., 1st Sess., p. 274 (1973). Also see Hearings Before the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, 89th Cong., 2d Sess., Vol. 2, p. 1793 (1966).

Thus, the multiple taxation of which Mobil complains occurs not from overlapping State apportionment formulas (J.S.App.C, p.26a) but from the compounding of tax after tax on the same foreign source income. *Moorman, supra,* does not govern the Commerce Clause issue in this case. Nothing could more discourage investment in the stock of foreign corporations than subjecting the dividend income therefrom to State income taxes of the type imposed by Vermont which gives no credit for the taxes previously imposed by the host foreign countries on the earnings out of which the dividends were paid or for the taxes imposed on the dividends by such host countries when paid to U.S. corporate shareholders. See Appendix A. (Vermont also does not allow the foreign tax credit to a domestic corporation operating outside the U.S. for the host foreign country's tax on foreign source earnings or for the tax on such earnings when remitted to the corporation in the U.S.)

In the past, this Court has not been reluctant to deny a State the right to tax income when to permit such taxations would give rise to multiple taxation. In *Evco, d.b.a. Instructional Designs* v. *Jones,* 409 U.S. 91 (1972), this Court declared a tax imposed on receipts from sales having a destination outside the taxing State to be constitutionally invalid because of the threat of multiple taxation. In so doing, it gave preference to the market State with respect to gross receipts taxes. See *General Motors Corp.* v. *Washington,* 377 U.S. 436 (1964). In the opinion of this Court, the market State has the greater claim when gross receipts taxes are in issue. By the same line of rea-

soning, the State in which the corporation receiving dividend income has its commercial domicile has the greater claim to the taxation of such dividend income, and other States should be denied the right to tax this income. Accordingly, if any of the dividend income of Mobil is to be subjected by decision in this case to tax by the separate States, only the State of Mobil's commercial domicile should be permitted to impose such a tax.

C. The Taxation Of The Foreign Source Dividends On An Apportioned Basis Is Invalid On The Ground That It Frustrates Federal Policy In Regulating Foreign Commerce.

As this Court noted in *Japan Line, supra,* foreign commerce is preeminently a matter of national concern, an area where Federal uniformity is essential. As this Court said, the Framers of the Constitution determined that "the Federal Government must speak with one voice when regulating commercial relations with foreign governments." Direct investments by U.S. corporations affect all fields of national and international trade. To a significant extent, the economic health of the United States depends upon the health of direct investments made in foreign countries by American corporations."[7]

[7] "Receipts to the United States from U.S. direct investment abroad amounted to $16.5 billion in 1977, including interest, dividends, fees, royalties and earnings of unincorporated affiliates. An offset of $5 billion representing net capital outflows for new direct investment abroad resulted in an $11.5 billion contribution to the U.S. balance of payments by our foreign direct investments last year.

The declared policy of the United States to encourage foreign trade and foreign investment by U.S. corporations is clearly reflected in various statutes and treaties, among them the *Foreign Assistance Act of 1961,* 22 U.S.C. §2351 which provides:

> (a) The Congress of the United States recognizes the vital role of free enterprise in achieving rising levels of production and standards of living essential to economic progress and development. *Accordingly, it is declared to be the policy of the United States to . . . encourage the contribution of United States enterprise toward economic strength of less developed friendly countries, through private trade and investment abroad.*
>
> (b) In order to encourage and facilitate participation by private enterprise to the maximum extent practicable in achieving any of the purposes of this chapter, the President shall:
>
> * * *
>
> (2) Accelerate a program of negotiating treaties for commerce and trade, including tax treaties, which shall *include provisions to encourage and facilitate the flow of private investment to, and its equitable treatment in, friendly countries and areas participating in programs under this chapter.*

Cumulatively from 1968 through 1977, the total returns on U.S. direct investment abroad amounted to some $104 billion, while the net capital outflows during the same period amounted to $39 billion, producing a positive contribution to the balance of payments of about $65 billion over this ten-year period, or an average of $6.5 billion per year. Clearly, our stake in international business is substantial and in turn the growth and strehgth of the American economy is significantly dependent on the growth of our overseas business." National Foreign Trade Council, Inc., "The Case for 'Deferral' ", p. 7 (August, 1978).

The Federal Government also evidenced its control over the areas of international trade in the *Export Administration Act of 1969*, 50U.S.C. App. §2402 which states:

> It is the policy of the United States . . . to encourage trade with all countries with which we have diplomatic or trading relations.
>
> It is the policy of the United States to use export controls to the extent necessary to further significantly the foreign policy of the United States.

Clearly, the United States Government has made the policy determination that U.S. direct foreign investment *is in the best interest* of the United States, and it considered the policy so important as to declare it by statute.

This Federal policy encouraging free foreign commerce is advanced by eliminating the onus of multiple taxation when the U. S. enters into tax treaties with foreign countries. In this regard U.S. income tax treaties were recently discussed by Donald C. Lubick, Assistant Treasury Secretary for Tax Policy, in his statement before the Senate Foreign Relations Committee on June 6, 1979. Preceding his discussion of Income Tax Conventions with Korea and with Hungary, an Estate and Gift Tax Convention with France and two Protocols amending, respectively, the proposed Income Tax Convention with the United Kingdom and the existing Income Tax Convention with France. Mr. Lubick stated:

> "Before discussing these Protocols and Conventions I would like to briefly highlight the Development of the U.S. tax convention program since the Treasury last appeared before this Committee on the subject of tax conventions in July of 1977. Since that time, we have continued to work to expand and improve the U.S. tax convention network. In the last two years, we have been engaged in discussions with twenty-six countries * and have had preliminary communications with several others. This represents an increase in the level of our activity on tax conventions which is attributable to several factors.

> *First, our experience during this period has been that more U.S. taxpayers are becoming aware of the value and importance of tax conventions—both as vehicles for confirming and clarifying the rules of taxation which apply to economic transactions between the two contracting states and as a means of facilitating the harmonization of different tax systems in order to resolve conflicts and to avoid double taxation. Both of these functions of a tax convention help to simplify the business decision-making process.*
>
> * * *
>
> . . . Moreover, developing countries seem more aware that an income tax convention with the United States *signals a positive attitude toward U.S. investment and, as such, may help to stimulate such investment.*
>
> * * *
>
> A tax convention is negotiated on behalf of the United States by representatives of the Treasury in consultation with the Department of State. Typically, our counterparts in a negotiation are representatives of the foreign tax administration. The public does not particpate in the actual government-to-government discussion. However, we have undertaken to keep the public aware of our scheduled negotiations and to provide the public with information about the positions we might be taking in particular negotiations. . . .

* * *

. . . When possible, we also try to indicate where it may be necessary to deviate from the United States' preferred negotiating position which is embodied in the U.S. Model Income Tax Convention which itself has been in the public domain since 1975. The U.S. Model, which was last revised in May of 1977, is similar, in many respects, to the Model Income Tax Convention published by the Organization for Economic Cooperation and Development. The United States also published a Model Estate and Gift Tax Convention on March 16, 1977. The United States is the only country which publishes its model tax conventions.

* * *

Finally, this increased activity can be attributed, in part, to changes in the tax law of either the United States or the foreign jurisdictions. Several of the Conventions and Protocals you are considering today were prompted by such changes.

* * *

The Protocal to the existing Income Tax Convention with France is also an example of a revision that is needed because of a change in foreign law. Effective *January 1, 1979, France will have a new tax law that significantly changes the French income tax liability of U.S. persons who reside in France. The Protocol is necessary to relieve the double taxation that will result when the new French law comes into effect.*" (Emphasis added; footnote omitted.) The Bureau of National Affairs, Inc., "Daily Tax Reports" No. 110 at J10, (June 6, 1979).

Multiple Taxation is avoided, generally, by the country hosting a shareholder granting credits for income taxes paid to foreign governments, by out-

right exemption of dividends from tax, or taxation of such income at substantially reduced rates. The United States, for example, as a matter of policy grants credits for income tax paid or deemed paid by U.S. shareholders to foreign governments with respect to foreign source income such as dividends (I.R.C. §§901-904). Similar provisions are contained in Article 23, Treasury Model Income Tax Treaty of May 17, 1977.[8]

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[8] 1. In the case of the United States, double taxation shall be avoided as follows: In accordance with the provisions and subject to the limitations of the laws of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income or capital the appropriate amount of tax paid to .....; and, in the case of a United States company owning at least 10 percent of the voting stock of a company which is a resident of ..... from which it receives dividends in any taxable year, the United States shall allow as a credit against the United States tax on income the appropriate amount of tax paid to ..... by that company with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid to ....., but the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources outside of the United States) provided by United States law for the taxable year. For purposes of applying the United States credit in relation to tax paid to ..... the taxes referred to in paragraphs 2(b) and 3 of Article 2 (Taxes Covered) shall be considered to be income taxes.

2. In the case of ....., double taxation shall be avoided as follows: In accordance with the provisions and subject to the limitations of the law of ..... (as it may be amended from time to time without changing the general principle hereof), the ..... shall allow to a resident or citizen of ..... as a credit against the ..... tax on income or capital the appropriate amount of tax paid to the United States; and in the case of a ..... company owning at least 10 percent of the voting stock of a company which is a resident of the United States from which it receives dividends in

Vermont has chosen to selectively follow the I.R.C.[9] and in so doing derogates from the I.R.C. provisions (§§901-904) related to dividens from foreign sources and foreign source earnings of domestic corporations,

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any taxable year. ..... shall allow as a credit against the United States tax on income the appropriate amount of tax paid to the United States by that company with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid to the United States, but the credit shall not exceed the limitations (for the purpose of limiting the credit to the ..... tax on income from sources outside of .....) prdvided by law for the taxable year. For purposes of applying the credit in relation to tax paid to the United States the taxes referred to in paragraphs 2(a) and 3 of Article 2 (Taxes Covered) shall be considered to be income taxes.

3. For the purposes of the preceding paragraphs of this Article, the source of income or profits shall be determined in accordance with the following rules:

(a) Dividends, as defined in paragraph 3 of Article 10 (Dividends) *shall be deemed to arise in a Contracting State if paid by a company which is a resident of that State* or if paragraph 5(c) of Article 10 (Dividends) applies.

(b) Interest, as defined in paragraph 2 of Article 11 (Interest), shall be deemed to arise in the State specified in paragraph 4 of Article 11.

(c) Royalties, as defined in paragraph 2 of Article 12 (Royalties), shall be deemed to arise in a Contracting State to the extent that such royalties are with respect to the use of, or the right to use, rights or property within that State.

(d) Except for income or profits referred to in subparagraphs (a), (b), or (c), and except for income or profits taxed by the United States solely by reason of citizenship in accordance with paragraph 2 of Article 1 (Personal Scope): *income or profits derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise in that other Contracting State.* (Emphasis added) Treasury Department's Model Income Tax Treaty of May 17, 1977, Article 23, Relief from Double Taxation.

[9] See Appendix A.

since it grants no credit for taxes paid or deemed paid to foreign governments. While penalizing the receipt of dividends from foreign subsidiary corporations and domestic corporations operating principally outside the U.S., Vermont would: (i) create a clear and present danger of multiple taxation of foreign source dividends and foreign source earnings of domestic corporations; and (ii) create a preference for dividends received from domestic subsidiary corporations and certain foreign corporations if 50% or more of their gross income from all sources is effectively connected with U.S. operations by allowing dividend received deductions. (I.R.C. §§243-247). See *St. Louis Cotton Compress Company* v. *State of Arkansas, supra,* and *State Board of Insurance* v. *Todd Shipyards Corporation, supra.*

Approval of the Vermont tax policies by this Court, would be to condone multiple tax burdens depleting domestic corporate investment capitol arising out of foreign operations and manifest a preference for investment capital arising out of U.S. operations, despite Federal policies to the contrary. As a result, the Nation as a whole would suffer. As this Court stated in *Japan Line, supra,* as 4482:

> If other states followed the taxing state's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this nation from speaking with one voice in regulating foreing comerce.

The economic consequences of the policy which Vermont seeks to pursue with respect to dividends received by domestic corporations having foreign investments, if duplicated by other States, could force domestic corporations to choose between:

(1) continuing business activites in their present form, suffering the depletion of repatriated foreign source earnings by multiple taxation before investment of such funds in the U.S. or elsewhere; or

(2) giving up the repatriation of the earnings of foreign corporations and vesting control of direct and indirect foreign investments in a foreign corporation to permit returns on investments to be recycled back into foreign corporations insulated from taxation by the various States in which U.S. operations are conducted.

The implications, albeit arguendo, of forcing such choices on U.S. corporations as they strive to compete in world markets are real, and following logically from sanctioning multiple income taxes and taxes which penalize U.S. companies for investments in foreign subsidiaries or for operating outside the U.S. To approve such State action, particularly when the United States is experiencing severe trade deficits, would place de facto control over foreign commercial policy in the several States and make decisions at the Federal level on this vital matter subservient to the day-to-day State revenue concerns.

CONCLUSION

For these reasons COST respectfully submits that the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of the Constitution of the United States are violated by Vermont's imposition of a tax on dividend income from domestic and foreign corporations.

Respectfully submitted,

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APPENDIX

APPENDIX A

Discrimination In Selectively Paralleling The Internal Revenue Code

The Vermont income tax law contains essentially the same definition of taxable income as the Internal Revenue Code. Vt. Stat. Ann., Title 32, §5811(18). (J.S.App.E, p.35a). Thus, items of income exempt under Federal law from State income tax are excluded from the Vermont tax base.

Under the Internal Revenue Code, a domestic corporation must include in gross income all items of income that are not specifically excluded therefrom by statute. This includes income from both sources within the United States and sources without the United States, as well as dividends from both domestic and foreign corporations. Foreign corporations are subject to tax in general only on income from sources within the United States. Except to the extent of the limited exclusion provided by I.R.C. §116, dividends paid by a domestic corporation to its individual shareholders are includable in their gross income.

In the case of a domestic corporation owning stock in another corporation, if the Internal Revenue Code did not prevent the unabated application of the foregoing rules, there could result three substantial Federal income taxes on the business income earned by the latter corporation: one on the corporation earning the business income, a second on the corporation receiving a dividend from the corporation earning the business income, and a third on the individual shareholders receiving a dividend. The Internal Revenue Code contains several provisions which are designed, in general, to prevent the imposition of multiple corporate income taxes in such cases. The policy underlying these provisions is that there should be only one significant Federal corporate income tax on the business income of a corporation and that no substantial, additional

Federal income tax should attach to that income until distributed as dividends to the individuals who indirectly own the stock of the corporation. See 2 Surrey, Warren, McDaniel and Ault, Federal Income Taxation—Cases and Materials 286-87 (1973); Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶5.06, at 5-18, 5-19 (3d ed. 1971).

The foregoing policy is implemented by I.R.C. §§243-247, I.R.C. §243 provides generally that a domestic corporation may deduct an amount equal to 85% of the dividends it receives from another domestic corporation. As a result, the payee corporation is subject to tax only on 15% of the amount of the dividend received. Under the present corporate tax rate structure, this results in a maximum Federal income tax of 6.9% of the dividends.

In the case of dividends received by a domestic corporation from another domestic corporation, at least 80% of the voting stock of which is owned by the payee corporation, the deduction allowable under I.R.C. §243 is equal to 100% of the amount of the dividend received. As a result, in such cases no Federal income tax is imposed on the payee on the receipt of such a dividend. Where this degree of stock ownership is present, I.R.C. §§1501-1504 permit the corporate group to file a consolidated Federal income tax return, in which case dividends paid by one member to another are eliminated. Treas. Reg. §1.1502-1504 permit the corporate group tp file a consolidated Federal income tax return, in which case dividends paid by one member to another are eliminated. Treas. Reg. §1.1502-14(a)(1).

The foregoing rules are also applicable to dividends received by a foreign corporation that is engaged in trade or business in the United States if the dividends are effectively connected with the trade or business.

As a general matter, no such deduction is allowable to a domestic corporation under the Internal Revenue Code with respect to a dividend from a foreign corporation. How-

ever, I.R.C. §245 provides a dividend received deduction of 85% or 100% with respect to dividends paid by certain foreign corporations subject to Federal income tax on their income from engaging in trade or business in the United States * In the case of foreign corporations operating abroad, double taxation of the business income of the payor corporation is avoided by means of the foreign tax credit. In this respect, I.R.C. §902 permits the payee corporation to take as a credit an appropriate portion of the foreign income tax of the payor if the payee owns at least 10% of the voting stock of the payor. As a result, even though such a dividend is included fully in the Federal income tax base, no Federal income tax is imposed on the payee if the foreign tax rate equals or exceeds the Federal income tax rate.

It is manifest that these rules relating to intercorporate dividends operate—albeit differently—in the context of the Federal tax system to ensure that the Federal and foreign corporate tax burden on business earnings of a corporation whose stock is not owned directly by individuals is not excessive by reason of the earnings being subject to multiple taxation. This is true whether the corporation is domestic or foreign and whether its business is conducted in the United States or abroad.

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* Under I.R.C. §245(a), if a foreign corporation has been engaged in a trade or business in the United States for an uninterrupted period of 36 months (or, if shorter, for its entire existence) and if the proportion of its total gross income during that period which is effectively connected with that trade or business is at least 50%, that proportion of a dividend paid by the foreign corporation qualifies for the 85% or 100% dividends received deduction. Under I.R.C. §245(b), if all of the stock of a foreign corporation is owned by a domestic corporation and if all of the gross income of the foreign corporation is effectively connected with the conduct of a trade or business in the United States, a dividend paid by the foreign corporation qualifies for the 100% dividends received deduction.

It is equally clear, however, that these rules in the context of the Vermont tax system result in a Vermont tax burden on dividends from foreign corporations operating abroad (the entire amount of which is included in the Vermont tax base without allowing any credit for foreign taxes) greatly exceeding the Vermont tax burden on dividends from domestic corporations or form foreign corporations operating in the United States (no more than 15% of which is included in the Vermont tax base). Allowing a foreign tax credit would, in some cases, eliminate this discrimination but would not where little or no foreign tax is imposed. Accordingly, wholly apart from the question whether Vermont may take into account dividends from corporations having no connection with Vermont, the Vermont tax system discriminates against investment in foreign corporations by domestic corporations and to that extent imposes a burden on foreign commerce that does not apply to domestic commerce. Thus the selective paralleling of the I.R.C., albeit administratively convenient, would appear to create classifications of taxpayers which violates the Equal Protection Clause of the Fourteenth Amendment to the Constitution.